

STATE OF ILLINOIS



ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission	:	
On Its Own Motion	:	
	:	
Rulemaking concerning the	:	
establishment of mandatory	:	02-0581
provisions for money pool	:	
agreements involving public utilities	:	
and incumbent local exchange	:	
carriers	:	

**VERIFIED SURREBUTTAL COMMENTS OF THE STAFF OF THE ILLINOIS
COMMERCE COMMISSION ON PROPOSED RULE ON MONEY POOL
AGREEMENTS**

The Staff of the Illinois Commerce Commission ("Staff") hereby submits its surrebuttal comments.

Staff filed its Verified Initial Comments and its proposed draft of 83 Ill. Adm. Code 340 on January 21, 2003 ("Staff Initial Comments"). On February 4, 2003, several parties filed written comments in response to Staff's Initial Comments and its proposed money pool agreement rule (company "Initial Comments"). Staff filed its Verified Rebuttal Comments and another proposed draft of 83 Ill. Adm. Code 340 on February 18, 2003 ("Staff Rebuttal Comments"). On March 5, 2003, the following parties filed written comments in response to Staff's Rebuttal Comments and its proposed money pool agreement rule: Union Electric Company and Central Illinois Public Service Company (collectively, "Ameren"), Citizens Telecommunications Company of Illinois

("CTC"), Commonwealth Edison Company ("ComEd"), Northern Illinois Gas Company ("Nicor Gas"), Utilities Inc. ("UI") and Verizon North Inc. and Verizon South Inc. (collectively, "Verizon") (hereafter, comments filed on March 5, 2003, by those companies are company "Rebuttal Comments"). Staff's revised proposed rule regarding money pool agreements is attached to these surrebuttal comments as Attachment 1. Attachment 2 is a clean copy of Staff's revised proposed rule.

A Money Pool Agreement Rule Will Enhance the Safety of Utility Funds

CTC believes that Staff's proposed rule precludes certain utilities from participating in a money pool arrangement. (CTC Rebuttal Comments at 2.) Contrary to CTC's claim, the proposed rule does not preclude certain utilities from participating in a money pool arrangement. The proposed rule allows utilities to borrow from affiliates provided the requirements set forth in Section 340.30 are met. No party to this proceeding has taken issue with the Section 340.30 requirements. The Section 340.40 requirements allow affiliates to borrow from utilities provided that the affiliate possesses sufficient backup liquidity sources to repay the short-term loan. Furthermore, Staff added two options for an affiliate to become eligible to borrow from a utility:¹ (1) the affiliate is a utility; and (2) the affiliate is a service company and the utility does not issue indebtedness to unaffiliated entities and (a) the utility is classified as small or (b) the utility demonstrates that the benefits associated with relying on an affiliate to provide the utility with capital exceed the risks associated with a decrease in the utility's financial independence and the affiliate is a medium-grade credit issuer.

¹ Hereafter, an affiliate that is eligible to borrow from a utility will be referred to as an "Eligible Borrower."

CTC claims that Staff's proposed rule undermines the effective process that the Commission has in place for reviewing affiliated loan agreements (Id.) Verizon claims that the Commission process has been in place for many years, works extremely well and does not need to be fixed. (Verizon Rebuttal Comments at 2.) Staff disagrees. The proposed rule enhances the Commission process for reviewing money pool agreements by laying out the minimum requirements for short-term loans between affiliates. The requirements for short-term loans to utilities from affiliates, as outlined in Section 340.30, prevent utilities from subsidizing affiliates through unreasonably high interest charges. The requirements for short-term loans to affiliates from utilities, as outlined in Section 340.40, enhance the safety of utility funds by ensuring that the funds utilities lend to affiliates will be repaid when due. Section 340.50 provides guidelines for investing utility surplus funds, thereby ensuring that money pool funds will be safe and accessible to its participants. The reporting requirements provided in Section 340.60 allow the Commission to monitor money pool agreement transactions and further ensure compliance with the rule. Finally, the establishment of minimum standards would streamline the process for reviewing money pool agreements by reducing the number of issues for litigation.

Ameren, CTC and Verizon assert that Staff has wrongly applied a "one size fits all" approach to money pool agreements involving Illinois utilities. (Ameren Rebuttal Comments at 2; CTC Rebuttal Comments at 10; Verizon Rebuttal Comments at 2-3.) This complaint is unjustified given that (1) of the fourteen parties that filed petitions to intervene that this rule would affect, only three, Ameren, CTC and Verizon, argue that

the rule is unnecessary and harmful;² and (2) the rule takes into account different money pool arrangements, including Ameren's unusual structure in which Union Electric Company borrows outside the money pool on behalf of other members of the Ameren money pool agreement.³

In its rebuttal comments, Staff provided three examples of companies using utility affiliates to obtain financing to the detriment of those utilities. (Staff Rebuttal Comments at 2-3.) Ameren and Verizon assert that Staff's examples are unrelated to money pool agreements. (Ameren Rebuttal Comments at 2; Verizon Rebuttal Comments at 2.) They are wrong. In November 2001, Enron directed its pipeline subsidiaries to enter into revolving credit agreements⁴ and loan the proceeds to Enron. The loans were part of Enron's attempt to hold off a declaration of bankruptcy, which occurred two weeks later. In March 2002, both pipeline companies informed Federal Energy Regulatory Commission ("FERC") Staff that neither expected to receive any repayment of their loans to Enron.⁵ The proposed rule would prohibit such transactions since under Section 340.40(a) utilities would only be permitted to loan externally borrowed funds to other utilities and service companies.

Section 340.10 Applicability

UI, the parent company of 24 small operating companies that are Illinois utilities, has a highly centralized cash management function that is essential to obtain efficiencies and economies of scale so that it may provide utility service in Illinois. For

² The Illinois Independent Telephone Association was excluded from the count of fourteen intervening parties since most of its members would not be subject to the rule.

³ See Section 340.40(a). An earlier draft of the rule would have prohibited Union Electric Company from borrowing outside the money pool agreement to lend to utility affiliate Central Illinois Public Service Company and non-utility affiliate Ameren Generating Company.

the UI utilities located in Illinois, customer bill payments are sent directly to a depository account in the name of UI's service company, Water Service Corporation ("WSC"). As WSC receives customer bill payments, each payment is applied to the customer's account while the revenues are booked directly to the appropriate utility subsidiary. None of the UI utilities (a) maintain a bank account; (b) directly pay any vendors, suppliers or employees; or (c) have any borrowings from third parties. (UI Rebuttal Comments at 1-2.) The Commission authorized the agreement by which WSC provides service to the utility subsidiaries in Docket No. 94-0157. (Order, Docket No. 94-0157, March 22, 1995.) Furthermore, UI does not have a published credit rating and accesses the capital markets through private placements to insurance companies and other institutional lenders. (UI Rebuttal Comments at 3.)

All of UI's common stock is owned by NV Nuon, which has an unsecured credit rating of Aa3/P-1 from Moody's Investors Service ("Moody's"). NV Nuon does not have ratings from any other nationally recognized rating agency. While UI's parent company may be willing to provide an unconditional guaranty of WSC's obligations to the utility subsidiaries, NV Nuon has a single rating which would not qualify it as a guarantor under the proposed rule (Id.)

UI is concerned that the cash management transactions between the utility subsidiaries and WSC could be considered loan transactions between affiliates and, therefore, subject to the requirements of the proposed rule. Due to the integrated nature of UI's cash management system, UI asserts that it would be very difficult and

⁴ A revolving credit agreement is a form of short-term loan.

⁵ Order to Respond, Federal Energy Regulatory Commission, Docket No. IN02-6-000, August 1, 2002.

expensive to comply with the proposed rule as provided in Attachment 1 to Staff's Rebuttal Comments. (Id. at 2.)

UI proposes that Section 341.10(b) exempt from Sections 340.30 and 340.40 certain water utilities that have three or more water utilities in the State and that use a service company for purposes of aggregating all customer receipts and paying all such water utility's vendors and other operating requirements, provided that the water utility (a) may not issue debt to any unaffiliated third parties; (b) uses a service company to conduct all cash flow operations; (c) is the beneficiary of a guaranty provided by a high-grade credit issuer (alternatively, has a high-grade committed credit facility) that satisfies Section 340.40(b)(2); and (d) demonstrates to the Commission that in lieu of interest payments or credits from the service company to the water utility for funds used or charges by the service company to the water utility for funds advanced, the overall cost of providing services to such water utility by the service company appropriately allocates to such water utility the costs, savings, and efficiencies of such cash flow system. (Id. at 3-4.)

Staff agrees that in some cases centralizing the cash management and treasury⁶ functions within a single affiliate provides significant economies that should be recognized in the rule. Nevertheless, Staff disagrees with several details in UI's proposal. First, Staff cannot justify treating small water utilities differently than similarly situated small utilities in other businesses. Second, limiting an exemption to utilities that are affiliates to three or more water utilities in the state has no financial and economic basis. Third, UI's proposal would require the Commission to evaluate the terms of a

money pool agreement pursuant to Sections 7-101 and 7-102 of the Public Utilities Act (“Act”) and determine whether a service company’s cost, savings and efficiencies allocation are reasonable. UI’s proposal places an undue burden on Staff and the Commission since the statutory requirements of Sections 7-101 and 7-102 of the Act do not address the allocation of savings and efficiencies. Such determinations are typically deferred to rate cases. Sections 7-101 and 7-102 establish public interest and public convenience standards, respectively and authorize the Commission to condition its approval of an affiliated interest agreement in a manner that achieves those objectives. (220 ILCS 5/7-101(3) and 5/7-102(C).) Section 7-101(2)(ii) addresses costs resulting from affiliated interest transactions to the extent it authorizes the Commission to prescribe guidelines which the electric or gas public utility must follow in allocating costs to transactions with affiliated interests. (220 ILCS 5/7-101(2)(ii).) Section 7-101(3) states that Commission consent of any contract or arrangement under Section 7-101 of the Act does not constitute approval of payments thereunder for the purpose of computing expense of operation in any rate proceeding. Thus, Staff objects to requiring the Commission to evaluate a service company’s cost, savings and efficiencies allocation with respect to Sections 7-101 and 7–102 of the Act for the purpose of exempting utilities from the proposed rule. Finally, for reasons that will be discussed in more detail in the context of Sections 340.30 and 340.40, Staff opposes UI’s proposed modification of Section 340.10(b) since it would inappropriately exempt certain utilities from the entire rule.

⁶ For the purpose of these comments, “cash management” shall refer to bill collections and payments, and the management of temporary cash surpluses and deficits (i.e., short-term loans); “treasury” shall refer to the acquisition and refunding of long-term capital such as common equity and long-term debt.

CTC observes that Staff's December 31, 2002, draft proposed rule included the following language in Section 340.10(b)(4):

Loans from utilities that do not issue long-term debt are not subject to the requirements of Sections 340.40 or 340.50.

CTC argues that this exemption, included in the draft proposed rule circulated before the hearing to establish the procedural schedule in this docket, was part of the reason CTC was willing to forgo a live contested hearing in this proceeding. (CTC Rebuttal Comments at 12.) CTC argues that if an Illinois utility does not borrow externally and issue debt to unaffiliated third parties, then the risk of companies using utility affiliates to obtain financing to the detriment of the utilities will not materialize. Accordingly, CTC proposes that Section 340.10(b) include the following exemption language:

Utilities that do not issue long-term debt to unaffiliated third parties are not subject to the requirements of Section 340.30 or Section 340.40.

(Id. at 13.) Even though CTC claims that Staff's prior proposal to exempt from Sections 340.40 and 340.50 utilities that do not issue long-term debt was part of the reason that it was willing to forgo a live contested hearing in this proceeding, CTC now proposes, without explanation, to exempt from Sections 340.40 and 340.30 utilities that do not issue long-term debt. Additionally, CTC does not explain why such utilities should be exempted from Section 340.30, Minimum Requirements for Short-Term Loans from Affiliates to Utilities and Section 340.40, Minimum Requirements for Short-Term Loans from Utilities to Affiliates. Staff submits that even if one accepted the premise that such utilities should be able to lend funds to affiliates that do not meet any of the eligibility criteria under Section 340.40(b), those limits regarding interest charges on loans to the utility contained in Section 340.30 are appropriate.

In its rebuttal comments, Staff opposed CTC's proposal to exempt from the rule utilities that do not issue long-term debt since a utility's internally generated funds would be at risk if they can be loaned to an affiliate. Staff explained:

A subsidiary may lend money short-term when it has a long-term but not a short-term need for that money. If a utility did not need those funds for the long-term, then that utility would declare a dividend to make a permanent capital distribution to its parent company. Thus, a utility that makes short-term loans is still putting needed funds at risk; hence the rule should apply to all such utilities.

The reference to a utility's option to declare a dividend to make a permanent capital distribution to its parent company rather than lending those funds on a short-term basis was not a recommendation. (Staff Rebuttal Comments at 3-4.) Rather, Staff explained that when a utility with two options to transfer cash to an affiliate chooses the one in which the utility expects to be repaid, that decision is *prima facie* evidence that the utility expects to need the money back, which in turn, means that the utility has put needed funds at risk. CTC misconstrues Staff's example as encouraging utilities to make dividend payments to parent companies rather than short-term loans. (CTC Rebuttal Comments at 13.)

The proposed rule does not encourage utilities to make dividend payments to parent companies when the financial condition of the utility would be impaired by such payments. To the contrary, Section 7-103 of the Act expressly requires that Illinois utilities suspend dividend payments if capital is impaired or would be impaired by such dividend payment. Furthermore, Section 7-103 of the Act authorizes the Commission to order a utility to cease and desist the declaration and payment of any dividend upon its common and preferred stock whenever the Commission finds that the capital of any

public utility has become impaired or will be impaired by payment of a dividend. (220 ILCS 5/7-103.)

CTC's claim that a utility "forced" to make dividend payments gives up its "right" to repayment is also specious. (CTC Rebuttal Comments at 13.) Utilities that are owned and controlled by another entity, with no independent board of directors, have no effective "right" to repayment of a loan to an affiliate. It is highly unlikely that CTC would sue its affiliate for repayment of a loan it extends to an affiliate. A utility such as CTC is repaid if and only if its parent company deems it in its interest to do so.⁷ Even if a parent company directed that loan be repaid to a utility, nothing but Section 7-103 of the Act prevents the parent company from also directing the utility to effectively reverse the loan repayment through a dividend payment to the parent company in an amount similar to the loan repayment.

As CTC observes, an earlier draft of Staff's proposed rule included an exemption for utilities that did not issue long-term debt. That exemption was drafted in recognition that some utilities' access to capital would be very limited on a standalone basis. Such a utility may significantly benefit if an affiliate with greater access to capital raised capital on behalf of the utility.

Staff eliminated the exemption for utilities that do not issue long-term debt because for some utilities, any gains that might be realized from centralizing the capital raising function, may be more than offset by increased risk resulting from a utility's complete dependence on non-utility affiliates for capital. Standard & Poor's ("S&P") has instituted a consolidated ratings methodology that explicitly takes into consideration the

degree of insulation between a utility and its affiliates in rating the utility's creditworthiness. When the ratings agencies found that insulation to be lacking, utility credit ratings have been lowered. For example, when CILCORP assumed debt from an affiliate, Midwest Energy, Moody's downgraded the credit ratings of CILCORP's utility subsidiary, Central Illinois Light Company ("CILCO"), from Aa2 to A2. Moody's explained, "Although CILCO's standalone credit fundamentals remain extremely robust, CILCORP's increased reliance on CILCO's cash flow to service holding company debt obligations limits the utility's long-term financial flexibility and therefore influences its rating...Both the CILCO and the CILCORP rating are heavily dependent upon each other's activities." (Moody's Investors Service, "Central Illinois Light Company Rating Review," October 4, 1999.) S&P took a harsher view of CILCORP's assumption of Midwest Energy debt. It downgraded CILCO's rating from AA- to BBB-. S&P explained that it did "not view CILCO as sufficiently insulated from CILCORP's much weaker financial profile. Thus, S&P's credit analysis focuses on the consolidated credit profile of CILCORP, which will erode significantly due to the assumption of debt issued by Midwest Energy." (Standard & Poor's Ratings Direct, "Central Illinois Light Ratings Downgrade, Off Creditwatch; Midwest Energy's Notes Rates," October 6, 1999.)

In explaining its consolidated rating methodology for utilities, S&P stated:

The consolidated corporate credit quality is the creditworthiness of an entire organization, regardless of whether securities are issued at the parent or subsidiaries. This is Standard & Poor's consolidated rating methodology. This is done if all subsidiaries or only one subsidiary out of many has rated securities. The reason is most, if not all, companies manage cash flows and cash needs efficiently throughout their organization and thus are flexible and fungible, whether the company is simple or complex in structure. In other words, money

⁷ Such self-interest may often, but by no means always, consider regulators' and outside creditors' responses to non-repayment. Of course, utilities without externally raised debt are not constrained by the interests and rights of outside creditors.

can flow freely in corporate entities whereby one subsidiary's cash surplus could support another subsidiary's expenditure if necessary. In our view, it is less important whether a company actually moves cash around the organization and more important whether the company is capable of moving money around the organization. In that case, a company's ability to meet its obligations is generally the same throughout the organization. (*Emphasis added.* Standard & Poor's Ratings Direct, "Utility Ratings Criteria for the Changing Times," October 8, 1998.)

S&P also explained that exceptions to the general consolidated rating rule would occur if sufficient insulation between the utility and its affiliates exists:

Standard & Poor's also searches for elements of insulation... that is, instances when a subsidiary may be insulated from the rest of the organization. State utility regulation is a form of insulation. Regulated subsidiaries are generally subject to restrictions on cash or asset transfers that are more likely to be enforced (by regulatory authorities, not the courts) than covenant restrictions protecting nonregulated subsidiaries. Because of this factor, normal criteria against rating a subsidiary higher than a parent or the consolidated corporate credit quality does not necessarily apply to a regulated subsidiary. (*Id.*)

To determine the degree of insulation between a utility and the rest of the organization, S&P looks at many factors, two of which are: whether there are common sources of equity or debt capital, and whether regulators have placed restrictions on dividends, advances, and loans to the parent or affiliates, or other company transactions. (*Id.*)

The consolidated ratings methodology also applies to telecommunications companies. S&P stated, "Although a subsidiary may – on a standalone basis – appear to be a better credit than its parent, the financially less creditworthy parent ultimately controls the subsidiary's financial actions and so can avail itself of the financial resources of the subsidiary." (Standard & Poor's, *Corporate Ratings Criteria*, 2002, at 46.)

Despite the concerns described in the ratings analysis above, UI's Rebuttal Comments indicate that some utilities need to be able to transfer money to an affiliate

as part of a larger system through which those utilities obtain funds for investment. Because Staff believes that small utilities should not be exempted from the entire rule, Staff has added additional options for an affiliate to become an Eligible Borrower. Those options are discussed in greater detail under Section 340.40(b).

Verizon proposes allowing the Commission to waive certain portions of the proposed rule when those portions applied to a particular agreement would be contrary to public interest. (Verizon Rebuttal Comments at 4.) Ameren and CTC support Verizon's proposal. (Ameren Rebuttal Comments at 9; CTC Rebuttal Comments at 10-11.) Such a waiver provision would require further language in order to comply with the requirements of the Administrative Procedure Act ("APA"). Pursuant to the APA, "each rule that implements a discretionary power to be exercised by an agency shall include the standards by which the agency shall exercise the power. The standards shall be stated as precisely and clearly as practicable under the conditions to inform fully those persons affected." (5 ILCS 100/5-20.) Ameren, CTC and Verizon have failed to include the necessary standards for granting a waiver therefore, the waiver proposal should be rejected.

Furthermore, Verizon also proposed this modification in its Initial Comments. In Staff Rebuttal Comments, Staff asserted that Verizon's proposal renders the rule superfluous. Verizon questions how providing the Commission the ability to act in a manner that is in the public interest can be described as "superfluous" since protecting the public interest is an important role of the Commission. (Verizon Rebuttal Comments at 3-4.) The answer is straightforward. Because each utility sees itself as unique in some way, each request for an approval of a money pool agreement would likely seek a

variance from the rule. Thus, the Commission would be asked to revisit the “requirements” of the rule over and over again. This would effectively reduce the rule from minimum requirements to suggested guidelines.

In support of its proposal, Verizon states:

During such times [of financial distress or bankruptcy], it is critical that companies have as much flexibility to structure financing arrangements as possible. This may mean that a subsidiary, including utilities, must borrow from a parent company that has poor credit quality, because it may be the only source of funds available to fund the subsidiaries’ operations. The proposed rule, because of its credit quality requirements, would put any financially distressed Illinois utility in a precarious financial position. This problem would be acute if the proposed rule does not provide the Commission the ability to waive provisions of the rule. This rule should allow the Commission to review such a proposal and not forgo its opportunities. (Verizon Rebuttal Comments at 4.)

The above argument mischaracterizes Staff’s proposed rule. Under Section 340.30 of the proposed rule, utilities may borrow from affiliates, including parent companies, regardless of the affiliate’s credit quality. However, to protect the financial condition of Illinois utilities, affiliates that borrow from Illinois utilities must meet one of the eligibility criteria provided in Section 340.40 of the proposed rule. Furthermore, Section 340.40 prevents a utility from borrowing externally in order to lend to non-utility affiliates. Thus, the proposed rule would not worsen the financial condition of a utility under financial distress. In fact, the proposed rule provides safeguards that would protect a utility from the financial distress of non-utility affiliates since such affiliates would be unable to borrow from a utility without having adequate credit ratings or back up sources of liquidity.

Section 340.20 Definitions

New Definitions

Staff's revised proposed rule adds definitions for the following: "Small utility" means a utility that has less than \$50,000,000 in total capitalization, as reported in the annual report the utility files with the Chief Clerk of the Commission; "Large utility" means a utility that has \$50,000,000 or more in total capitalization, as reported in the annual report the utility files with the Chief Clerk of the Commission. The rationale for this distinction is explained in more detail in Section 340.40(b).

Staff's revised proposed rule defines total capitalization as "the sum of short-term debt, long-term debt, preferred stock and common equity for the entire company." This definition is referenced in the definitions of small utility and large utility. The phrase "for the entire company" means that totals are to be used for each component of the capital structure rather than Illinois jurisdictional amounts. "Cash management" means collecting or aggregating customer receipts and paying all vendors and other operating requirements. Cash management is referenced in Section 340.40(b)(7). The definition of "service company" has been expanded to include service companies providing services to utilities pursuant to a service agreement that has been approved by the Commission under Sections 7-101 or 7-102 of the Act. Finally, "medium-grade credit issuer" means a company that has the following issuer credit ratings from at least two of the following three major credit rating agencies and a higher, equivalent or no credit rating from the third credit rating agency: BBB or above by Standard & Poor's or its successor; Baa2 or above by Moody's Investors Service or its successor; or BBB or above by Fitch Ratings or its successor. This term is part of the criteria for becoming an Eligible Borrower pursuant to Section 340.40(b)(7)(B).

High-Grade Credit Issuer

CTC, Ameren and Verizon propose that the current minimum credit ratings requirements for high-grade credit issuer and high-grade committed credit facility (i.e., A-/A3/A-) be lowered to allow investment grade credit ratings (i.e., BBB-/Baa3/BBB-).⁸ (CTC Comments at 2; Ameren Comments at 3; Verizon Comments at 5.)

According to CTC, investment grade credit ratings provide strong assurance of the repayment of a loan from an Illinois utility to an affiliate; thus, investment grade ratings should be the lowest qualifying credit rating benchmark the Commission includes in the proposed money pool rules. CTC cites the Fitch Corporate Bond Default Study: A Decade in Review published by Fitch Ratings on November 8, 2001, (“Fitch Study”) as support for its proposal. CTC notes that the weighted one-year corporate default rate for a company with a long-term investment grade credit rating was 0.05%. (CTC Rebuttal Comments at 8.) The Fitch Study did not examine short-term debt obligations, which require additional back up liquidity sources that are not required for long-term debt obligations. As stated in Staff’s Rebuttal Comments, long-term credit ratings are useful indicators of short-term credit worthiness only to the extent they correlate with short-term ratings. The convergence of S&P’s A- long-term credit rating and A-1 commercial paper (“CP”) rating is rare. The proposed rule permits companies rated A- to borrow from a utility without a specified minimum level of committed credit facilities, which already represents a compromise to the A-1/P-1/F-1 standard. An A- long-term credit rating is a reasonable criterion for short-term loan obligations since an

⁸ The credit ratings are presented in the following order: Standard & Poor’s/Moody’s Investors Service/Fitch. This convention is adhered to throughout these comments.

A- credit rating indicates that the obligor has a strong ability to meet its financial commitments. However, S&P states that BBB-rated obligations are more susceptible to adverse economic conditions or changing circumstances. (Staff Rebuttal Comments at 5-6.) Consequently, a short-term liquidity crisis would more likely impair a BBB-rated company's financial condition than it would an A-rated company. According to S&P, BBB- credit ratings correspond to an A-3 CP rating. (Staff Rebuttal Comments, Attachment 2 at 1.) According to Fitch Ratings, BBB- credit ratings correspond to an F-2 or F-3 CP rating. (*Id.* at 2.) Not even Ameren, CTC or Verizon have gone so far as to suggest that a Tier 3⁹ CP rating is adequate. Nonetheless, CTC argues that the BBB- should be the long-term credit rating standard in the proposed rule. Undoubtedly, allowing a BBB- long-term credit rating standard in the proposed rule would provide little assurance of repayment for debt obligations since (1) BBB- is the lowest investment grade credit rating available, and is very close to a speculative credit rating; and (2) a BBB- long-term credit rating generally accompanies a Tier 3 CP rating, which, absent 100% liquidity backup, provides insufficient assurance for the safety of utility funds when lent to affiliates on a short-term basis, thereby, undermining the purpose of the proposed rule.¹⁰

CTC also argues that a long-term credit rating encompasses an entity's ability to repay all its obligations, short and long-term. (CTC Rebuttal Comments at 7.) That is untrue. S&P, Moody's and Fitch Ratings maintain separate credit ratings for short and long-term obligations and issuers of short and long-term obligations. In defining its "issue" credit ratings, S&P states:

⁹ "Tier 3" refers to S&P's A-3 CP rating, Moody's P-3 CP rating and Fitch Ratings' F-3 CP rating.

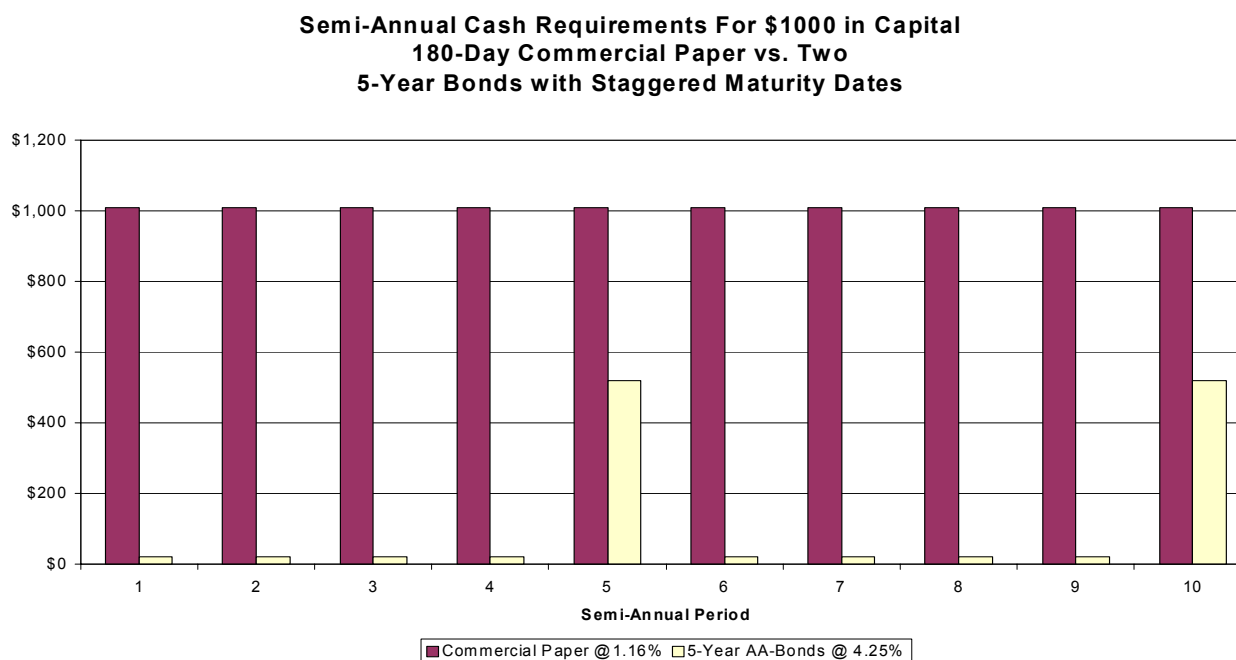
¹⁰ Both S&P and Fitch Ratings require 100% liquidity backup for Tier 3 CP.

A Standard & Poor's issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program (including ratings on medium term note programs and commercial paper programs)...Issue credit ratings can be either long-term or short-term. Short-term ratings are generally assigned to those obligations considered short-term in the relevant market. In the U.S., for example, that means obligations with an original maturity of no more than 365 days – including commercial paper. (Standard & Poor's Ratings Direct, "Standard & Poor's Ratings Definitions," December 10, 2002.)

In defining its "issuer" credit ratings, S&P states, "Issuer Credit Ratings can be either long-term or short-term. Short-Term Issuer Credit Ratings reflect the obligor's creditworthiness over a short-term time horizon." (*Id.*) Moody's defines its short-term issuer credit ratings as, "opinions of the ability of issuers to honor senior financial obligations and contracts. Such obligations generally have an original maturity not exceeding one year, unless explicitly noted." (Moody's Investors Service Ratings Definitions, "Prime Rating System," Moodys.com.) Fitch Ratings states, "A short-term rating has a time horizon of less than 12 months for most obligations, or up to three years for U.S. public finance securities, and thus places greater emphasis on the liquidity necessary to meet financial commitments in a timely manner."¹¹ (Fitch Ratings Definitions, "International Short-Term Credit Ratings," fitchratings.com.)

¹¹ "Public Finance" refers to "debt of state and local governments and their authorities...Issuing entities include cities, counties, school districts, and municipal enterprise systems such as water and sewer districts, toll road authorities and airports." (Fitchratings.com.)

Contrary to CTC's representations, long and short-term credit ratings are not interchangeable. Short-term debt places far greater demands on the cash flows of a company since the principal must be repaid with far greater frequency. The graph below illustrates the greater cash flow required for a short-term borrowing program. It compares the cash flow requirements of maintaining \$1000 of capital through two strategies: 180-day CP and two \$500 five-year bonds, issued 2.5 years apart. The CP requires the borrower to find a market for \$1000 in debt every six months. The 5-year bond strategy requires the borrower to find a market for \$500 in debt every 30 months. Clearly, the shorter the term to maturity of the debt issue, the greater the liquidity required to support it.



According to Ameren, lowering the long-term ratings requirements to BBB/Baa2/BBB would result in a negligible increase in credit risk based on observed default rates at these rating levels. (Ameren Rebuttal Comments at 3.) Ameren cites a Moody's analysis ("Moody's Study") that indicates firms that eventually default have very low ratings long before the default event. Specifically, over 90% of all rated companies that have defaulted since 1983 were rated Ba3 or lower at the beginning of the year in which they defaulted, and almost 80% were rated Ba3 or lower at the beginning of the fifth year before they defaulted. Ameren suggests that it is highly likely that the utility lender and the Commission would have ample warning of the increased risk of default by the affiliate borrower even if BBB-/Baa3/BBB- borrowers were allowed under the proposed rule. (*Id.* at 5-6.) Like the Fitch Study, the Moody's Study does not provide sufficient evidence that the definition of high-grade credit issuer should be changed to investment grade credit issuer since it sheds no light on the ability of credit issuers to repay short-term obligations absent Tier 1 CP rating or committed credit facilities.

Ameren also proposes allowing affiliates with A-2/P-2/F-2¹² CP ratings to borrow from utilities. (Ameren Rebuttal Comments at 9-10.) Ameren argues that the additional default risk for a P-2 rated CP issuer is negligible in comparison to that of a P-1 rated CP issuer. (Ameren Rebuttal Comments at 3.) While factually correct, Ameren's argument is misleading. "Moody's defines a commercial paper default as any delayed, foregone, or incomplete disbursement of principal or interest." (Moody's Investors Service, "Commercial Paper Defaults and Rating Transitions, 1972-2000," October 2000 at 12.) Moody's definition of default does not include instances in which the CP

issuer had to draw on backup sources of liquidity, such as a committed credit facility, to refund CP.¹³ Consequently, default rates are not a useful means for determining the minimum credit rating that should be used in this rule. To determine whether a particular credit rating represents sufficient assurance that an affiliate can repay its short-term loan to a utility, one would need to know the rate that borrowers with that credit rating were forced to resort to committed credit facilities and other backup sources of liquidity to avoid default. However, the Moody's Study does not provide such statistics.

The default rate for P-2 CP is only minimally higher than that for P-1 rated CP because credit rating agencies such as Moody's require issuers of P-2 CP to maintain committed bank credit facilities. Moody's states:

In assessing short-term credit quality, a critical concern relates to how a company would repay maturing CP if, perhaps due to market turbulence, a decline in credit quality, or investor reluctance to reinvest, it were unable to roll it over. To address this potential problem, Moody's ratings analyses place a great deal of weight on the company's liquidity and its access to alternative sources of liquidity. Typical characteristics of highly rated short-term issuers are large size, backup liquidity provisions, high and stable earnings, and substantial stocks of liquid assets. (*Id.* at 9.)

Further, Moody's notes that default rates on CP are low due to the "Orderly Exit" mechanism:

The orderly exit mechanism refers to the fact that a weakening of an issuer's credit quality is typically accompanied by a refusal by investors to roll over maturing CP, thus forcing the issuer from the market. Firms forced to exit the market must replace maturing CP with alternatively and presumably less convenient, forms of financing that are more consistent with low-investment grade or speculative grade credit quality. (*Emphasis added. Id.* at 17.)

¹² Tier 1 CP ratings are A-1/P-1/F-1. The A-2/P-2/F-2 CP ratings are also known as "Tier 2" CP ratings.

¹³ In fact, Moody's states that a failure of defaulting CP issuers' banks to provide sufficient funds to meet CP obligations as other lenders pulled back from the market caused a surge in CP defaults between 1989

Note Moody's use of the phrase "low-investment grade" in the preceding quote. "Low-investment grade" refers to BBB/Baa/BBB ratings. Thus, Moody's clearly contradicts Ameren's assertion that BBB/Baa/BBB ratings are sufficient for borrowing on a short-term basis from Illinois utilities without committed credit facilities. Moody's provides an example in support its opinion:

Toward the end of 1995, in the midst of a deteriorating credit position, Kmart held a Baa1 long-term debt rating that was on review for a downgrade, but a P-2 CP rating that was not on review. Nevertheless, Kmart's CP dealer advised the company not to try and issue any additional CP at that time. Without the ability to roll over existing CP during its seasonal liquidity low, Kmart instead chose to draw down on \$500 million in bank facilities. (Id.)

The Moody's Study also underscores the rapidity with which liquidity crises can occur. Two days before Columbia Gas Systems defaulted on its CP, Moody's had rated that CP P-2, the rating with which Ameren's proposed Baa long-term credit rating conforms. (Id. at 14.)

Thus, the low default rate on P-2 rated CP does indicate that credit rating or the corresponding long-term credit rating Baa are sufficient for borrowing on a short-term basis from utilities. The Moody's Study clearly indicates that P-2 rated CP issuers must have committed credit facilities to reduce the risk that a sudden withdrawal of credit will precipitate a liquidity crisis that leads to default.

CTC recommends removing the "high-grade" requirement from the "high-grade committed credit facility" definition. According to CTC, a committed credit facility is a contractual obligation to provide funds and is not conditioned on the credit rating of the committing financial institution. (CTC Rebuttal Comments at 4.) CTC argues that the

and 1992. (Moody's Investors Service, "Commercial Paper Defaults and Rating Transitions, 1972-2000," October 2000 at 12-13.)

double protection involving both a back up source of liquidity and ensuring that the financial institution is a high-grade issuer is excessive, inconsistent with industry practice for back up credit facilities and should be eliminated. CTC argues that money pool participants create a shared liquidity resources and it is unlikely that each participant will have simultaneous demands for capital. (*Id.* at 5.) Fitch Ratings' guidelines for CP ratings contradict CTC's position. With regard to the creditworthiness of banks providing liquidity backup for CP programs, Fitch Ratings states, "In general, the weighted long-term Ratings of the banks providing credit should be A or better; commitments provided by banks BBB+ or lower are not included in the calculation of CP backup." (Fitch Ratings, "Corporate Commercial Paper Liquidity Guidelines," April 24, 2001.) For the same reasons given with respect to high-grade issuers, a high-grade committed credit facility enhances the safety of utility funds. Thus, the requirement for a high-grade committed credit facility should remain in the proposed rule.

On February 24, 2002, the Securities and Exchange Commission ("SEC") designated Dominion Bond Rating Service Limited ("Dominion") a Nationally Recognized Statistical Rating Organization ("NRSRO"). According to Verizon, if the proposed rule is not modified to recognize Dominion as a valid credit rating agency, then Illinois utilities will not be able to take advantage of lower credit rating fees that could result from competition in the credit rating industry. (Verizon Rebuttal Comments at 3.) Staff opposes Verizon's proposal. First, Dominion's description of its rating review process is insufficient for determining whether Dominion's long-term and CP credit ratings are scaled similarly to those published by S&P, Moody's and Fitch Ratings. Dominion's long-term investment grade credit ratings are designated AAA (highest), AA

(superior), A (satisfactory) and BBB (adequate) whereas Dominion's CP credit ratings are designated R-1 (i.e., prime credit quality), R-2 (i.e., adequate credit quality) and R-3 (i.e., speculative credit quality). Dominion also uses "high", "middle" or "low" as subset grades to designate the relative standing of the credit within a particular rating category. (DBRS Rating Scale, www.dbrs.com.) Although Dominion's long-term investment grade credit rating scale appears similar to the long-term investment grade credit rating scale used by S&P, Moody's and Fitch Ratings, the same is not true with respect to CP credit ratings. S&P, Moody's and Fitch Ratings describe Tier 1 CP obligors as strong, Tier 2 CP obligors as satisfactory and Tier 3 CP obligors as adequate. (Standard & Poor's Ratings Definitions, December 10, 2002; Moody's Investors Service Ratings Definitions, www.moody.com; Fitch Ratings Definitions, www.fitchratings.com.) Thus, Dominion's R-2 CP rating appears to correspond closely with S&P, Moody's and Fitch Ratings' Tier 3 obligors; and, it follows that Dominion's R-1 (low) or R-1 (middle) CP rating would correspond to S&P, Moody's and Fitch Ratings' Tier 2 CP ratings, which unlike Tier 1 CP ratings, require additional backup liquidity sources. Due to the differences between the CP rating scales used by S&P, Moody's and Fitch Ratings and the CP rating scales used by Dominion, Staff opposes including Dominion credit ratings in the proposed rule at this time. Second, Staff has not found any published documents revealing the relationship between Dominion's long-term and CP credit ratings. Third, currently no Illinois utilities have been assigned a long-term or short-term rating by Dominion. If Illinois utilities are assigned credit ratings by Dominion, then a technical change could be made to the rule to include Dominion as a credit ratings agency.¹⁴ A technical

¹⁴ Staff does not rule out adding Dominion's ratings to the rule in the future as more is learned about Dominion's rating scales and credit criteria.

change of this nature should require relatively little time, which would not harm Illinois utilities.

Verizon proposes that references to specific credit ratings agencies through the proposed rule be moved to Section 340.20. Furthermore, Verizon proposes defining eligible credit ratings agencies as those designated an NRSRO by the SEC. Verizon suggests that this proposal would enable the proposed rule to withstand restructurings within the credit rating industry. (Verizon Rebuttal Comments at 5.) Although Staff does not disagree with the intent of Verizon's proposal, the SEC does not publish or otherwise provide a list of credit ratings agencies with the NRSRO designation. Thus, Staff would be unable to determine whether a given credit ratings agency has received the NRSRO designation; and, given the credit ratings agency received the NRSRO designation, whether it remains in compliance with the SEC requirements for the NRSRO designation. Thus, Staff objects to Verizon's proposal since it would be difficult to implement. Furthermore, investigation would be necessary to determine how a new NRSRO's credit rating scale compares to existing NRSRO credit rating scales.

Section 340.30 Minimum Requirements for Short-Term Loans from Affiliates to Utilities

No party to this proceeding has objected to any provision contained in Section 340.30 of the proposed rule. Nonetheless, UI proposes that proposed rule exempt certain small water utilities from Sections 340.30 and 340.40 and CTC proposes that the proposed rule exempt utilities that do not issue long-term debt to unaffiliated third parties from Sections 340.30 and 340.40. (UI Rebuttal Comments at 4; CTC Rebuttal Comments at 13.) Staff opposes exempting any utility from Section 340.30 since it

provides minimum guidelines for short-term loans extended to a utility from its affiliates. Specifically, Section 340.30 requires that the terms of a short-term loan to a utility from an affiliate are provided in the form of a promissory note or in the money pool agreement itself; prohibits a utility from borrowing from its affiliates if it can borrow at a lower cost from another lender; and prohibits affiliates from charging a utility an interest rate on a short-term loan that exceeds the affiliate's actual interest cost. Neither UI nor CTC provide any rationale for exempting a utility from those minimum requirements.

Section 340.40 Minimum Requirements for Short-Term Loans from Utilities to Affiliates

Section 340.40(a)

Section 340.40(a) would prohibit a utility from borrowing outside the money pool agreement to make loans to non-utility affiliates that are not service companies or subsidiaries. Staff proposes exempting service companies and utility subsidiaries from the general prohibition against a utility lending externally to non-utility affiliates since service companies and utility subsidiaries are often established to provide services that directly benefit the utility. Staff opposes any money pool agreement proposal that would permit utilities to lend externally borrowed funds to any non-utility affiliate whose business or purpose is not directly related to the provision of services to utilities.

Nicor Gas proposed that Section 340.40(a) allow a utility to borrow outside the money pool agreement to make short-term loans to its parent company, when that parent owns 100% of the outstanding capital stock of the utility and maintains at least two of the following CP ratings: A-1/P-1/F-1 and a higher, equivalent or no credit rating from the third credit rating agency. Nicor Gas' proposal includes an interest rate

premium of 25 basis points for loans that a utility extends to its parent company. (Nicor Gas Rebuttal Comments at 1-2.) Staff opposes Nicor Gas' proposal. Given that Standard & Poor's published long-term and CP credit ratings are AA/A-1+, respectively, for both Nicor Gas and its parent company, the benefits resulting from Nicor Gas borrowing funds externally to lend to its parent company are doubtful at best. Both companies presumably have equal access to the capital markets given their equal credit ratings. Thus, the only logical reason that a parent company would prefer to borrow from its utility subsidiary would be to lower borrowing costs to both the utility and parent company. If so, then the parent company should raise the short-term capital and lend it to the utility, thereby reducing the utility's exposure to liquidity risk.¹⁵

CTC also proposes permitting utilities to borrow externally to lend to its parent company. Neither Nicor Gas nor CTC explain what utility or public interest is furthered by this proposal. As stated in Staff Rebuttal Comments, utilities should not assume unnecessary risks by incurring debt obligations for the benefit of non-utility affiliates. Moreover, money pool agreements are not vehicles for subsidies between utility and non-utility affiliates. Thus, permitting parent companies to borrow funds a utility raised outside the money pool agreement would undermine the objectives of the proposed rule by eliminating the safeguards intended to protect the utility's financial condition.

Section 340.40(b)

In Staff's Rebuttal Comments, it changed Section 340.50(a) to include a phrase previously contained in Section 340.50(a)(1). Accordingly, the Section 340.50

¹⁵ A parent company is exposed to the liquidity risk of a subsidiary regardless of whether the utility issues short-term debt to unaffiliated interests or that parent company borrows externally and lends the proceeds

subsections were renumbered to reflect this change. Staff's attached proposed rule includes a technical change to Section 340.40(b)(2) that reflects the renumbering of subsections under Section 340.50 in Staff's Rebuttal Comments.

Ameren states, "In addition to the financial wherewithal afforded by a solid financial condition (as evidenced by investment grade credit ratings), the continued creditworthiness of Ameren's regulated utilities will be supported by responsible regulation." (Ameren Rebuttal Comments at 5.) Staff recognizes that regulatory oversight provides a higher degree of safety for utility funds in comparison to unregulated entities. Staff revised its proposed rule to allow short-term loans from utilities to affiliates that are also utilities as defined in Section 340.20. Attachment 1 to Staff's surrebuttal comments reflects this revision to the proposed rule.

Although Staff does not agree with the details of UI's proposed revisions to the rule, UI's Rebuttal Comments indicate that affiliates should be eligible to borrow from certain utilities if that affiliate provides cash management services to a utility that would be unable to efficiently raise debt capital on a standalone basis. Specifically, Staff recommends adding the following paragraph to Section 340.40(b):

(7) The affiliate provides the utility cash management services through a Commission-approved agreement and the utility does not issue bonds, notes or other forms of indebtedness to persons or entities that are not affiliates of the utility and:

A) The affiliate is a small utility; or

B) The utility demonstrates that the benefits from relying on an affiliate to provide all the utility's capital exceed the risks associated with a decrease in the utility's financial independence provided that the affiliate is a medium-grade credit issuer.

to the utility subsidiary.

Staff recommends two alternative paths for obtaining the above-proposed exemption depending on the size of the utility for the following reasons. First, the smallest utilities would benefit most from a centralized treasury function. Banks are typically the only source of capital for small utilities that raise their own capital. Bank debt is relatively costly and usually imposes terms and conditions that make it difficult for a company to maintain an appropriate capital structure.

Nevertheless, there are risks associated with depending on affiliates for all capital. As mentioned above, the utility loses a degree of its insulation from non-utility, unregulated businesses. The ability of the affiliate to raise capital on behalf of the utility will depend on that affiliate's financial strength, which in turn, will depend on the operating risks associated with the participating affiliate's primary businesses. Those downsides to integration indicate that eligibility under Section 340.40(b) should not be automatic for all affiliates. Thus, Staff recommends an option for an affiliate to become an Eligible Borrower under Section 340.40(b) of the proposed rule provided certain criteria are met.

In Section 340.20, Staff defines small utilities as those utilities with total capitalization of less than \$50,000,000 and large utilities as those utilities with total capitalization equaling or exceeding \$50,000,000. \$50,000,000 represents the midpoint total capitalization of (1) utilities that have previously or would be able to issue debt and remain viable operating utilities and (2) utilities that have relied on bank loans for financing operations. Staff's review of Illinois utilities reveals that a substantial gap exists between the total capitalization of companies that rely on bank debt and those that do not rely on bank debt. Consumers Illinois Water Company, with a December 31,

2001, capitalization totaling \$94,396,040, is the smallest Illinois utility that could likely issue non-bank indebtedness.¹⁶ In comparison, Mt. Carmel, with a December 31, 2001, capitalization totaling \$10,231,287, is the largest Illinois company that has been limited to bank loan financing. Using the midpoint of those companies' total capitalization as a starting point, i.e., \$52,313,664, Staff recommends using \$50,000,000, to define the dividing line between a small utility versus a large utility for the purpose of the proposed rule.

Staff's revision to Section 340.40(b) would designate an affiliate as an Eligible Borrower from a large utility provided: (1) the affiliate provides utility cash management services through a Commission-approved agreement; (2) the utility does not issue indebtedness to non-affiliates; and (3) the utility demonstrates to the Commission that the benefits resulting from its reliance on an affiliate to raise its capital exceed the risks resulting from its lower degree of financial independence provided the affiliate is a medium-grade credit issuer as defined in Section 340.20. For the purpose of this exemption, a lower credit quality standard than otherwise required in Section 340.40 is acceptable. That is, the utility's burden pursuant to Section 340.40(b)(7)(B) is such that a minimum degree of assurance of repayment for utility funds must exist; otherwise, it would be impossible to demonstrate that risks resulting from an affiliate raising all of a utility's capital is offset by the benefits resulting from such an arrangement.

Ameren suggests that Section 340.40(b)(2), which provides an option for affiliates borrowing from Illinois utilities to have high-grade committed credit facilities totaling the amount of outstanding short-term debt in lieu of a high-grade credit rating or

¹⁶ Staff excluded Illinois Consolidated Telephone Company from this analysis since the company was purchased at the end of 2002 and retired all of its outstanding debt.

CP rating, is excessive for purposes of a money pool agreement. (Ameren Rebuttal Comments at 7.) In support of its proposal, Ameren distinguishes between the CP investor who has access to only public information, including published credit ratings, regarding a given CP issuer and the bank that has access to more information regarding a borrower and its able to conduct more rigorous due diligence review of the borrower before making the decision of whether to lend to a given borrower. According to Ameren, the relationship between borrowing and lending utility affiliates is more analogous to the bank-borrower relationship than that of a CP investor and borrower. (Id. at 8.) Staff disagrees with Ameren's analogy. A bank-borrower relationship involves two parties negotiating to reach a mutually beneficial deal. The bank-borrower relationship involves self-interest on both sides that relationships between affiliated money pool participants lack. Thus, despite the greater access to information that a utility would have regarding an affiliated borrower, a utility might lend to that affiliate under circumstances that an unaffiliated bank would not.

Further, both Ameren and CTC argue that a centralized treasury function, which is aware of the cash needs and liquidity of the entities participating in the pool, mitigate default risk. (Ameren Rebuttal Comments at 4-5; CTC Rebuttal Comments at 5.) Any mitigation of default risk through centralization of the treasury function will depend upon the skills of management. Nevertheless, centralized management also fosters conflicts of interest that can be and have been detrimental to utilities. Unquestionably management faced with a faltering, cash starved affiliate has an incentive to advance it cash from stronger sister companies. [See S&P quote on consolidated rating methodology.] This occurred at Enron when management had two utility subsidiaries

draw on bank credit facilities and advance those funds to the parent company. Bad intentions are not a necessary condition for managers to engage in such a cash-balancing act. Enron management may have believed its actions would avoid a bankruptcy and that in due time, Enron would reimburse its subsidiaries. Good intentions or not, Enron management clearly placed the interests of Enron (and perhaps itself as well) above those of the utility subsidiaries. Thus, Staff does not agree that the awareness gained from centralized treasury function is sufficient to relax credit requirements given the inherent conflicts of interest of managers of holding companies.

Ameren claims further that the bank market providing committed credit facilities is shrinking, in part because committed credit facilities are low profit transactions. (Ameren Rebuttal Comments at 8.) Staff notes that Section 340.40(b) provides various eligibility criteria for short-term loans from utilities to affiliates other than a high-grade committed credit facility. Alternatively, the borrower may be a high-grade credit issuer, have a high-grade CP rating, or have the borrowed funds guaranteed by a high-grade credit issuer or an entity with a high-grade CP rating. Further, Ameren exaggerates bank reserve requirements. Fitch Ratings reveals that banks are not required to hold capital against commitments of less than one year. (Fitch Ratings, "Corporate Commercial Paper Liquidity Guidelines," April 24, 2001, at 5.) Consequently, many credit facilities are for periods of 364 days. Further, most reserve requirements top out at 10% of the liability. (Federal Reserve System Reserve Maintenance Manual, at V-1.) Hence, Ameren's exaggeration of bank reserve requirements undermines the credibility of its claim of limited credit availability.

CTC argues Staff's proposed rule effectively makes it more burdensome and less attractive for a parent or any affiliate of a utility to provide funds to the utility. (CTC Rebuttal Comments at 7.) CTC's argument is based on a false premise. The proposed rule distinguishes between borrowing and lending requirements for utilities. Section 340.30 of the proposed rule does not include credit rating requirements for utilities to borrow from affiliates, including parent companies. On the other hand, in the interest of protecting Illinois utilities from financial distress, Section 340.40 includes several options for demonstrating the safety of utility funds when companies borrow from utility affiliates on a short-term basis.

CTC recommends that the proposed rule explicitly allow utilities to show that transactions between a utility and its affiliates do not create a risk for consumers when the utility and its affiliate do not meet the Section 340.40(b)(1) through (6) requirements. (CTC Rebuttal Comments at 11.) The proposal is essentially a request for a waiver from Section 340.40. Staff disagrees for the reasons given in response to Verizon's waiver proposal in Section 340.10. CTC's proposed language is too vague and does not provide an objective standard by which to monitor CTC's proposed criteria.

Regarding its waiver proposal, CTC states:

Staff's Rebuttal Comments erroneously presume that its three isolated mechanisms of High Grade commercial paper ratings, High Grade Committed Credit Facilities and High Grade Issuer credit ratings are the only means to demonstrate liquidity and ensure the repayment of an affiliate loan. Myriad of other financing options, including granting of a security interest on assets (such as receivables), or long- and short-term multi-party financing arrangements may be viable and preferable options to Staff's "one-size-fits-all" rule. (Id.)

Staff opposes CTC's proposal. Granting a security interest on assets such as receivables results in utilities exchanging cash for less liquid assets. CTC's proposal

exposes utilities to the uncertainty of if and when customers pay the amounts due to the utility's affiliate. Moreover, CTC's proposal would expose utilities to the risk inherent in affiliates' businesses.

CTC's reference to long- and short-term multi-party financing arrangements is too vague to be a reasonable alternative for the purpose of the proposed rule. Currently, Section 340.40(b)(2) of the proposed rule allows an affiliate to borrow from a utility if the aggregate amount of outstanding short-term debt of the affiliate, includes amounts to be borrowed from the utility, excluding amounts drawn on the committed credit facility, does not exceed the unused balance of funds available to the affiliate under high-grade committed credit facilities at any time, plus the amount of funds the affiliate invests in interest-bearing bank accounts and U.S. Treasury securities. The proposed rule allows interest bearing bank accounts and U.S. Treasury securities as collateral for short-term loans since they are safe and highly liquid investments, unlike receivables. CTC has had two opportunities to make proposals for specific alternatives but has failed to do so. CTC's proposal should be rejected.

ComEd proposes that Section 340.40(d) require that a utility receive from its affiliate a return no lower than it would have received on its existing investments. (ComEd Rebuttal Comments at 2.) In its rebuttal comments, Staff objected to ComEd's proposal, stating, "ComEd's proposal would permit an affiliate to borrow at interest rates that are below interest rates that the affiliate would have to pay in the market... this proposal could allow a utility to unjustly subsidize affiliates." (Staff Rebuttal Comments at 11.) ComEd argues that a subsidy would result only if a utility would otherwise invest in a vehicle providing a higher return than it is already earning on its invested funds,

thereby bearing a cost in order to benefit its affiliate. ComEd states further that there is no evidence that a utility is foregoing a benefit in order to make a loan to an affiliate. (ComEd Comments at 3.) Staff considers ComEd's argument reasonable and withdraws its objection to ComEd's proposal. Staff's revised proposed rule, included as Attachment 1, includes ComEd's proposal.

Section 340.50 Investment of Surplus Funds

Verizon proposes modifying Section 340.50 to reflect Verizon's position that investment-grade credit ratings are adequate to protect the public. (Verizon Rebuttal Comments at 5.) Staff disagrees with Verizon's proposal for the reasons set forth in response to Verizon's same argument regarding Section 340.20.

Section 340.60 Required Filings and Procedures

With respect to Staff's Section 340.40(b)(7) provision, Staff has added a new provision under Section 340.60(a) that clarifies Section 340.60 does not apply to small utilities as defined in Section 340.20. Accordingly, Staff modified the remaining Section 340.60 subsection headings to reflect the new Section 340.60(a) provision.

CTC argues, "Staff has neither identified any additional benefits associated with the Commission receiving daily transaction information nor committed that Staff would regularly review the gargantuan reams of data that the dozens of Illinois utilities will provide. Instead of the required filing of detailed daily transaction documentation, regulated utilities and telecommunication carriers should only be required to include month end balance information in their quarterly report. (CTC Rebuttal Comments at

16.) Staff opposes CTC's proposal. The Section 340.60 reporting requirements are necessary given the Commission does not have access to the same level of information that a utility has. Staff's recommended reporting requirements require only a fraction of the data that a well-informed cash manager would need to be knowledgeable of cash flows throughout a company. For example, Staff's proposal does not include daily cash deposits and disbursements of affiliates that do not involve loans to and from utilities. Furthermore, CTC's proposal would give utilities an opportunity to bury excessive loans to affiliates. That is, in a given month, a utility could lend to its affiliates an amount that exceeds the amount allowed under the proposed rule under the assumption that the utility will be repaid by the end of the month. Enron expected it could repay its pipeline affiliates short-term loans, but Enron was wrong. A utility could make the same mistake as Enron. CTC's proposal is particularly troubling since it is unclear how CTC would know that it was exceeding loan limits given that it does not track the day-to-day cash position of CTC. Finally, the quantity of data that Staff seeks pursuant to Section 340.60 is not as large as CTC claims. A quarter comprises 13 weeks; given that there are 5 business days in a week, the report need not exceed 65 rows of data per utility. Staff is fully prepared to review reports of this magnitude.

CTC claims that it is unclear why a month-end report would not provide a sufficient level of detailed information to the Commission, especially since the data will not be submitted to the Commission until 30 days after the end of the calendar or fiscal quarter. (CTC Rebuttal Comments at 15.) CTC implies that data that is 30 days old is not useful. Staff disagrees. Section 340.60 is designed to ensure compliance with the proposed rule by allowing Staff to monitor transactions between utilities and affiliates

pursuant to Commission-approved money pool agreements. The task of monitoring transactions is not designed to immediately reverse transactions in which utilities and affiliates do not adhere to the rule. Rather, it allows Staff to check on utility compliance after the fact, thereby, reducing the incentive to “cheat” and promoting future compliance with the rule.

CTC argues that Staff’s proposal to report daily loan activity is inconsistent with general industry reporting practices. (CTC Rebuttal Comments at 15.) Staff asserts that daily balances are appropriate due to the short-term nature of money pool agreement transactions. For example, Ameren’s money pool transactions are made on a daily or overnight basis. (Ameren Rebuttal Comments at 4.) Furthermore, one approach used by S&P to evaluate a short-term borrower for a commercial paper rating requires the borrower have sufficient liquidity to cover short-term obligations coming due in the time required to arrange additional funding. S&P presumes that firms rated A-1 and A-2 should be able to arrange additional funding within 30 days and 90 days, respectively. (Standard & Poor’s Corporate Ratings Criteria at 80-81.) Thus, contrary to CTC’s claim, the capital markets, including commercial paper markets, are concerned with day-to-day loan balances and activity. (CTC Rebuttal Comments at 16.) Daily balances are essential for ensuring that the utility is complying with the proposed rule. Monthly balances would not provide sufficient detail for this task.

CTC asserts that to the extent the Commission believes it needs and specific situations warrant the review of daily detailed transaction information, the Commission’s Staff can request this information from the specific companies. (CTC Rebuttal Comments at 16.) Staff opposes CTC’s proposal. While the Commission has the

authority to request utilities to provide “...documents, books, accounts, papers and records in its possession in such form as the Commission may direct...” (220 ILCS 5/5-102), under CTC’s proposal such a request would be fruitless with respect to historical transactions if the utility does not maintain such historical information in the form requested by Staff in this rule. Furthermore, under CTC’s proposal, Staff on an ongoing basis would be obligated to send data requests for daily transactional information to all Illinois utilities subject to the rule since Staff would not know if a utility is complying with the rule without that information. Thus, limiting the reporting requirement to monthly information would not reduce the burden of compliance monitoring for either utilities or Staff.¹⁷

CTC proposes modifying Section 340.60(d) to add the following two sentences at the end of the provision:

Absent further investigation and an order from the Commission, the credit rating agency downgrade will not be deemed a violation of these rules or trigger any requirement to restructure the loan from the utility to the affiliate. (CTC Rebuttal Comments at 17.)

CTC argues that Staff has provided no explanation why a debt rating downgrade by one or more rating agencies should automatically trigger a violation of the Commission’s money pool agreement rules and should require immediate repatriation of funds from the downgraded affiliate. (*Id.*) Staff asserts that credit rating downgrades represent deteriorating credit quality. Thus, downgraded affiliates should not be allowed to continue to borrow from utilities even though such affiliates once complied with the Section 340.40 eligibility criteria. Furthermore, CTC’s proposal requires additional

¹⁷ This argument assumes that the Commission decides to reduce the frequency of data required in the report from daily to monthly on the grounds that Staff could data request daily data if Staff deems it

investigation and a Commission Order before a credit rating downgrade may be deemed a violation of the rule. CTC's proposal would require a Staff report to the Commission before the Commission would open such a proceeding. Once the Commission opens a proceeding, time must be allotted for pre-hearing conferences, testimony, evidentiary hearings, briefing and writing a proposed order. By the time those events occur, the damage to a utility's financial condition could be irreversible.

Despite those concerns, Staff agrees that borrowers should be granted a grace period to repay outstanding loans or time to get back into compliance with the rule. Staff recommends that if an affiliate borrower is no longer in compliance with the Section 340.40 requirements (i.e., the borrower is downgraded below the credit ratings thresholds established in Sections 340.20 and 340.40 or the affiliate borrower does not have sufficient back up liquidity sources as required by Section 340.40) at the same time it has outstanding short-term balances due to the utility, then the proposed rule should prohibit the utility from lending additional funds to the downgraded affiliate until the affiliate is again in compliance with the proposed rule. Furthermore, the rule would allow the affiliate 90 days from the day the credit rating downgrade occurs to comply with the proposed rule. However, Staff believes this language is more suitable for Section 340.40 rather than Section 340.60. Specifically, Section 340.40(g) provides:

A utility shall neither lend additional funds nor extend the term of existing loans to any affiliate that no longer meets any of the eligibility criteria of subsection (b) [of Section 340.40]. An affiliate that exceeds its borrowing limit shall have 90 days to repay sufficient principal and accrued interest to bring that affiliate back into compliance with subsection (b) or, alternatively, to repay all outstanding loans from the utility and accrued interest.

necessary. If the Commission decides that daily data is not necessary to ensure continuing compliance with the rule, then Staff would not seek that data through discovery.

Finally, Staff made technical changes to the following sections of the proposed rule: Section 340.20, 340.40, 340.50 and 340.60. Those technical changes are presented in Attachment 1.

For the foregoing reasons and those stated in its Verified Initial Comments and Verified Rebuttal Comments, Staff respectfully requests that the Commission adopt Staff's proposal in this proceeding.

Respectfully submitted,

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